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The National Industrial Recovery Act

By WALTER A. STAUB

Even a cursory reading of the National Industrial Recovery Act (hereinafter referred to simply as "the Act"), indicates that the stress of the depression and the mandate of the electorate last fall for a "new deal" have led to the abandonment—for at least the time being—of the "rugged individualism" which has been the guiding policy of industry in America since colonial days; that the majority in an industry may now exercise control over the minority which may heretofore have been unwilling to "play ball"; that the antitrust laws are being set aside and what was formerly sternly forbidden may now be permitted, namely, price-fixing and other forms or elements of "restraint of trade" which may result in increasing the prosperity of industry with corresponding benefit to the labor employed therein; and that finally the government is empowered to exercise a controlling hand over industry which embodies the substance, if not the form, of a dictatorship.

The Trade Association

The redeeming feature of the Act just passed is that it does not actually put the government into business unless or until business fails to do its utmost to utilize the possibilities of the new law to bring about industrial recovery. Business men who have for years complained about the hampering restraints of the antitrust laws and of the destructive tactics of an obstreperous and destructive minority in an industry, now have their opportunity to demonstrate what can be accomplished with these disturbing factors removed or controlled.

The most helpful feature of the bill is its provision for recognition of the trade association and the conferring upon it of powers to enable it to function effectively. In any industry in which a trade organization, at present existing or yet to be formed, sets up a code of fair competition with a view to recognizing and safeguarding the respective interests of employers, employees and consumers, and such association functions satisfactorily, government control in that industry will probably be passive rather than active. In the case, however, of any industry which does not take active steps to rule itself, the Act confers broad powers on the government to set up a code of competition through the medium of an agreement or a license.

In the event that an industry or group does not, through a trade association, set up for itself a code of fair competition, or does not enter into a voluntary agreement which will accomplish the same purpose, the President,

after public notice and hearing, is empowered to license individuals, partnerships or corporations to carry on the business in which they are engaged. The license may be suspended or revoked for violation of the terms or conditions thereof.

Codes of Fair Competition

Every code of fair competition (as well as every agreement or license) approved under the law must contain the following conditions:

1. Employees have the right to organize and bargain collectively through representatives of their own choosing;
2. No employee and no one seeking employment shall be required to join any organization or to refrain from joining any labor organization;
3. Employers shall comply with maximum hours of labor, minimum rates of pay, maximum machine-load of employees, and other conditions of employment approved or prescribed by the President.

To be acceptable, the code must be that of an association or group which imposes no inequitable restrictions on admission to membership therein and which is truly representative of the trade or industry or subdivisions thereof for which it purports to speak. The code must not be designed to promote monopolies or to eliminate or oppress small enterprises nor operate to discriminate against them. Further, the code must tend to carry out the purpose of the Act.

Prior to its approval, a hearing is to be granted any persons engaged in other steps of the economic process who believe their services or welfare may be affected by such code. Also, the President may impose such conditions and provide such exceptions to and exemptions from the provisions of the code as he deems essential for the protection of consumers, competitors, employees and others, or in furtherance of the public interest.

An effective code of fair competition must contain more provisions than those already mentioned which are compulsory under the Act. One would naturally be the making of reports and keeping of accounts. It is specifically mentioned in the Act as one which the President may require as a condition of his approval of the code, but even if not required by him, it would be essential to the effective functioning of the trade association in the interest of its members.

Some other matters which it may be desirable to cover in the code but which are not specifically required under the Act, are as follows:

Development of uniform cost accounting procedures
Advertising policies
Product and market researches and analyses
Budgeting methods
Plan for determining sales prices which would yield fair profit on capital employed
Prevention of waste in production
Ethical business conduct
Exchange of operating statistics such as:
  Units of product on hand by classes or groups
  Unfilled orders (units classified)
  Production (units classified)
  Shipments (units classified)
  Average costs by units for all members
  Credit data.

Few, if any, association members would willingly submit unit cost data to others in the same line of industry but they are sometimes very much interested in the average unit cost of all members. The same thing may be said as to certain other data, such as the sales or shipments by the various members, which would be helpful to the trade association but which individual members do not wish to disclose directly to their competitors. Such in-

formation may be received confidentially by an independent agency, such as a certified public accountant, who assembles it in such a way that the identity of the individual members from whom it is received is not disclosed. In the case of cost data, for example, he may compute average unit costs for all members and only such average cost information is issued to all the members. Similarly, the sales or shipments data gathered from members may be collated and made available—whether by totals, by territories, by classes of commodities or products, or otherwise—without any individual member's figures being separately disclosed or being in the direct possession of the association where it might be subject to, or come to the attention of other members.

The matters referred to above may not be included in the codes first filed, as the National Recovery Administration, headed by General Johnson, is evidently most concerned with applying first of all the employment ("spread the work") and minimum wage provisions of the Act, so as to reduce as rapidly as possible the number of unemployed and to increase the purchasing power of the nation. Other phases of the problem, such as that of fixing or controlling prices, are apparently being left for subsequent consideration as the need therefor becomes evident.

It is obvious, however, that it will not be possible to restrict very long the activities of either the trade associations or the Recovery Administration to wage scales and working hours. Other matters, such as determination of prices and quotas, and those mentioned in the foregoing list will have to receive consideration if the full purpose of the Act is to be accomplished.

Limited Codes of Competition

It is the intent of the Act that so far as possible standards as to maximum hours of labor, minimum rates of pay and other necessary working conditions shall be reached by mutual agreement of employers and employees in the industry. In the event that such mutual agreement is not reached by voluntary action within the industry, the President is empowered to "investigate the labor practices, policies, wages, hours of labor, and conditions of employment in such trade or industry or subdivision thereof; and upon the basis of such investigations, and after such hearings as the President finds advisable, he is authorized to prescribe a limited code of fair competition fixing such maximum hours of labor, minimum rates of pay, and other conditions of employment in the trade or industry or subdivision thereof investigated as he finds necessary" to effectuate the purpose of the Act.

Price-fixing

Price-fixing is not specifically named among the powers granted trade associations through approval of a code of fair competition or of an agreement between the President and those engaged in a trade or industry. It seems evident, however, both from the legislative history of the Act and from certain of its provisions, that trade associations or industries may be permitted to confer and agree upon prices for their products, so long as excessive prices or monopolistic practices do not result.

No specific mention of regulation of production within an industry by a trade association appears in the Act,

but effective price control, and especially prevention of the fall of prices to an uneconomic level, implies regulation of production. Consequently, for the same reasons referred to with respect to price-fixing or control, it may be assumed that it is the intent of the Act that proper and reasonable control of production, as, for example, agreement upon production quotas by members of a trade association shall be permitted.

While the Senate had the Act under consideration, Senator Borah had the following provision inserted: ". . . such code or codes shall not permit combinations in restraint of trade, price fixing, or other monopolistic practices . . ." It is significant that this provision was deleted in conference between representatives of the Senate and House before the final passage of the Act. The startling power given the President to drive any individual, partnership, association, trust, or corporation out of business by refusing to give it a license, or by suspending or revoking a license previously given, to do business, is to be exercised "whenever the President shall find that destructive wage or price cutting or other activities contrary to the policy of this title are being practiced in any trade or industry." Further, it is provided that during the effective period of the Act and "for sixty days thereafter, any code, agreement, or license. . . . and any action complying with the provisions thereof . . . shall be exempt from the provisions of the antitrust laws of the United States."

It seems clear from the foregoing that business men will now have the right to confer regarding, and agree upon, fair prices for the products of their industry, without that fear of prosecution under the antitrust laws which heretofore hung over them. This fear has heretofore been a deterrent to such action, no matter how desirable or even imperative it appeared to be, not merely from the standpoint of their immediate interest but also from that of their employees and the public, which in the final analysis must also suffer from ruinous competition or the sale of goods at less than cost of production and a fair profit thereon.

Foreign Competition

The fear has been expressed that, even though from a domestic standpoint, it may be desirable to provide for maximum hours of labor and minimum rates of wages, higher costs of production are almost certain to result, and this may result in increased imports from foreign countries with depreciated currencies and/or lower standards of living. For example, mention has repeatedly appeared in the newspapers during the past year of increasing imports of low priced manufactured articles from Japan, where the yen has fallen to a low exchange value. The Act endeavors to meet such a situation by authorizing the President to permit entry into the United States of any articles which are being imported in substantial and increasing ratio to domestic production of any competitive articles and on such terms or under such conditions as to render ineffective or seriously to endanger the maintenance of any code or agreement under the Industrial Recovery Act, only upon such terms and conditions and subject to the payment of such fees and to such limitations in the total quantity which may be imported as he shall find essential to avoid rendering such code or agreement ineffective.

Briefly stated, it would appear that the President is given unrestricted power to impose such import duties and to limit import quotas to meet the exigencies of such a case as that above indicated.

Licenses

No American Congress, even under the pressure of war conditions, ever passed a more revolutionary legislative provision than the section of the Act which, if the President determines that destructive wage or price-cutting or other apparently harmful activities are being practiced in any industry, forbids any business being carried on in such industry unless it obtains a license therefor from the President. For violation of the terms or conditions of the license, it may be suspended or revoked.

The coercive power of such authority is tremendous. Without it, however, the Act would be without teeth and might be practically unenforceable.

Administrative Agencies

Broad powers are given the President for the administration of the Act and he has the widest latitude with respect to delegating his functions and powers to any officers, agents or employees whom he may select. Further, he may establish an industrial planning and research agency to aid in carrying out the Act. This goes a long way toward laying the ground for a national planning board somewhat similar to the War Industries Board which controlled the industries of the country during the World War by allocating materials, establishing production quotas, giving transportation priorities, fixing prices, etc. Suggestions for such a peace time industries board named by the government have been repeatedly made since the inception of the depression period by writers in newspapers, magazines and books. It seems unlikely, however, that the President will actually create such a planing board, especially one with power to enforce its plans, if the present improvement in general business gains momentum and it becomes evident that we have finally "turned the corner." In any case, it hardly seems possible that the administration will find time in which to create such a board and have it function satisfactorily within the life of the Act, which is not more than two years.

Receiverships and Bankruptcies

By Percival H. Granger, Esq.
of the Philadelphia Bar

There is considerable confusion of thought in regard to the meaning of the word receivership. This confusion exists not only among laymen, but among lawyers who are not specialists in this line. An old philosopher said, "Define your terms." Therefore, in considering this subject we must be careful to define our terms. We must distinguish between a receiver in equity and a receiver in bankruptcy.

What do you mean when you refer to a receiver? If you are talking about an equity case, it is one thing; if you are discussing bankruptcy, it is quite a different thing. If you are referring to a case in the state court, you have one situation, and if you refer to a case in a federal court, you have another situation.

Both in equity and bankruptcy a receiver is a mere custodian. He has no title to the assets and never acquires title thereto, except in a few states where he is given title to the assets by virtue of a statute. Such statutes exist in New Jersey, New Mexico, New York and possibly a few other states.

In an equity proceeding, the court assumes that the receiver is conserving the property and may restore it to the stockholders. Of course, in many instances such restoration is impossible owing to the heavy liabilities. Therefore, in such cases the receiver must liquidate.

In its historic origin, when a bill in equity was filed it asked for equitable relief of various kinds, and the appointment of a receiver was merely incidental to the relief prayed for. This has changed considerably in actual practice, so that both the court and counsel know at the outset when a bill in equity is filed containing several prayers for equitable relief, including the appointment of a receiver, that the primary purpose of filing the bill is to procure the appointment of a receiver.

In an equity case, a proceeding for the appointment of a receiver may be instituted in either the state or federal court. If instituted in the state court, so far as Pennsylvania is concerned only a temporary receiver may be appointed without notice, and in order to have the appointment made permanent, a further hearing with notice to all creditors and stockholders must take place. There need be no diversity of citizenship and no jurisdictional amount of $3,000 involved.

In the federal court, however, if the bill is filed by a creditor, he must be a nonresident of the state and must have a claim of more than $3,000, exclusive of interest and costs. If the bill is filed by a stockholder, he must be a nonresident of the state and must show that the amount in controversy, exclusive of interest and costs, exceeds $3,000. If the plaintiff is a simple contract creditor, the defendant corporation must file a consent answer in order to obtain the appointment of a receiver.

Failure to distinguish between pro-

ceedings in the state court, where no diversity of citizenship and no jurisdictional amount is required, and a proceeding in the federal court where such requirements exist, was illustrated by a recent case in the state court. Some able lawyers and judges were apparently of the opinion in that case that a consent answer to a bill filed by a simple contract creditor would give the court the right to appoint permanent receivers without notice to creditors and stockholders, although the equity rules of that state specifically provided otherwise. The court finally, after hearing, treated the appointment of the receivers in that case as a temporary appointment and fixed a later date for making it permanent after notice to creditors and stockholders.

No receiver in equity can be appointed for an *individual* in any court, state or federal, in Pennsylvania. The defendant must always be a corporation or a partnership. The rule is different in some other jurisdictions.

A receiver in equity, either state or federal, in Pennsylvania is, as above stated, a mere custodian and has no title to the assets of the defendant and no right to sue for their recovery in any other jurisdiction. This is subject to the qualification that a receiver appointed by the Common Pleas Court of one county in Pennsylvania is given jurisdiction anywhere in that state.

On the other hand, a receiver appointed by the federal court in the Eastern District of Pennsylvania has no control over the assets or right to sue therefor in either the Middle or Western Districts of Pennsylvania.

In order to acquire custody over assets located in other jurisdictions and bring suit to recover them, it is necessary to have ancillary receivers appointed in the other jurisdictions. Theoretically, the ancillary receivers are appointed *in aid* of the main rereceiver and should always act in cooperation with him. This is the rule both in equity and in bankruptcy. However, a majority of the courts hold that it is discretionary with the court appointing the ancillary receiver how far local creditors will be protected as against local assets in that jurisdiction. Furthermore, when the question of accounting for such ancillary assets arises, it is also discretionary with the ancillary court whether it will require local creditors to prove their claims and make allowances to ancillary receivers and counsel, or remit all assets to the court appointing the original receiver.

In bankruptcy a receiver is also a mere custodian and has no title to the assets. However, he is appointed for only a limited time until the trustee is elected. Immediately upon the election and qualification of the trustee, title to all assets wherever located immediately vests in the trustee. This rule is so strict that in a recent case the United States Supreme Court held that a mortgagee who had failed to start foreclosure proceedings before the bankruptcy petition was filed, must apply to the bankruptcy court itself for leave to foreclose irrespective of where the property in question might be located. From a practical standpoint, this often works a great hardship. The real estate involved may be two or three thousand miles from the jurisdiction in which the bankruptcy proceedings were instituted.

If an ancillary receiver in bankruptcy has been appointed in another jurisdiction, all his rights cease immediately upon the election of the trustee,

and in such cases it is the duty of the ancillary receiver to file an account immediately, and, after allowances of counsel fees, commissions and other administration expenses, turn over all assets in his possession to the trustee.

In bankruptcy cases there is a clear-cut line of demarcation between a voluntary proceeding and an involuntary one. In a voluntary case, the person or corporation filing the petition does not have to be insolvent. Mere inability to pay debts that accrue in the ordinary course of business is sufficient, and immediately upon the filing of the petition, an adjudication of bankruptcy is entered and a reference made to a referee.

In an involuntary bankruptcy case, the petition must be filed by three creditors unless the total number of creditors is less than twelve. One of the acts of bankruptcy stated in the bankruptcy statute must be averred, such as preferential payment to a creditor, a fraudulent transfer of assets, the appointment of a receiver while insolvent, admission of inability to pay debts and willingness to be adjudged a bankrupt on that account, etc. An answer may be filed by the bankrupt demanding a jury trial, or by any creditor. If filed by a creditor, the hearing is before the court without a jury.

Whether the bankruptcy is voluntary or involuntary, a receiver in bankruptcy may be appointed upon the application of creditors in order to protect the assets pending the election of a trustee. As above stated, such receiver is like an equity receiver—a mere custodian who has no title to the assets. He has no other powers than those given him by statute and in the order of appointment. Of course, the whole ultimate aim of a bankruptcy proceeding is liquidation.* However, in these unusual times new things are happening in the world every minute. For example, there is an unusual situation with regard to a large corporation which is now going through voluntary bankruptcy with the idea of a reorganization. Such a situation was almost unknown until the present time.

An important opinion rendered by Justice Roberts in the United States Supreme Court holds that the filing of a voluntary bankruptcy proceeding is not equivalent to an assignment for the benefit of creditors. Such bankruptcy petition is a mere pleading. The adjudication of bankruptcy is the act of the court and not the act of the party filing the pleading, although, of course, such party has set the machinery in motion which results in an adjudication of bankruptcy.

A trustee in bankruptcy when elected has title to all the assets, as above stated, and his title dates back to the date of filing the petition in bankruptcy. He can do many things which a receiver in equity cannot do because of the broad powers given him in the bankruptcy act itself.

Our firm is engaged in running a receivership in equity for a hosiery mill. The receivership started in the federal court in Pennsylvania in December, 1930. The majority of the assets were located in Pennsylvania. There was, however, a very substantial building erected by this corporation in another state some time before the receivers were appointed. The money for the erection of this building was obtained by selling preferred stock to numerous individuals. The receiver was ap-

* *Ed.—Under the amendment of March 3, 1933, to the Federal Bankruptcy Act, the aim of the proceedings may be in some cases a composition to avoid liquidation.*

pointed upon a bill in equity filed by a simple contract creditor with a consent answer thereto. It became necessary to have ancillary receivers appointed in other jurisdictions to protect the assets there. In that state there is a peculiar statute enacted over fifty years ago which provides that in case of receivership local creditors shall have priority of payment over general creditors as against local assets. This statute was held unconstitutional by the United States Supreme Court some thirty years ago in so far as it attempted to discriminate against individuals and partnerships who were nonresident of that particular state where the ancillary receiver was appointed. The statute, however, was held constitutional in so far as it related to nonresident corporations who had not become domesticated in that state. The great majority of the creditors are nonresident corporations. The creditors of the ancillary jurisdiction are insisting that they have the right to receive a dividend out of the local assets and then prove their claims as against the assets in Pennsylvania even if it results in giving them a larger pro rata dividend than the other creditors will receive. We insist that this cannot be done because it is a well established principle of equity that equality is equity and this principle is particularly applicable in the distribution of insolvent estates.

Now let me make some practical suggestions with regard to linking up receiverships with accounting problems.

First—It is absolutely essential that careful preparation should be made by both the accountant and the lawyer before proceeding to trial in any court or before any master. This preparation should be by teamwork. In other words, the accountant is very apt to look at the problem as a matter of bookkeeping. The lawyer is very apt to look at it from a purely legal standpoint. Both these angles are, of course, important. However, they must be coordinated. The lawyer should explain to the accountant the high points in the case; otherwise, accountants will make some surprising answers to questions put to them on the witness stand and sometimes unwittingly help to lose the case. If the accountant thinks of the job merely as a bookkeeping or accounting one, he will entirely lose sight of the legal problem and practical situation involved. Lawyers are probably as much to blame for this lack of teamwork as accountants. They often request a transcript of accounts receivable, accounts payable, etc., or analyses of certain accounts without telling the accountant in advance what relation these papers have with reference to the legal problem with which the lawyer is confronted. The lawyer should always explain to the accountant the high spots in a case.

Second—Another practical suggesgestion I would make is one with which I have had great difficulty in the past. When accountants are requested to prepare certain transcripts or analyses of accounts they should put proper headings on them and explain just what they mean. Don't head an exhibit "Accounts Receivable" unless it is a complete transcript of the accounts receivable. If it is merely partial, such fact should be shown in the heading. This is particularly important from the standpoint of the lawyer in the preparation of the case and of the judge in deciding it. If the head-

ings of the exhibits are not properly worded anyone is liable to become confused. It is the lawyer's job to explain to the accountant that what he is trying to prove is not merely a problem of figures, but he is trying to prove the whole case—one of the steps which involves a problem of figures.

Third—Another practical suggestion I would make is this: When questions are put to accountants on the witness stand under cross-examination, they should listen carefully and not give a blanket answer, "Yes" or "No," but "Yes" or "No" with qualifications. The reason is that the whole purpose of the cross-examiner, particularly if he is crafty, is to confuse and muddle the witness and, if possible, show that he does not know what he is talking about. On the other hand, if the accountant is under direct examination, a "Yes" or "No" answer without qualification is preferable if it can possibly be given.

To sum up: Preparation by the lawyer and the accountant are absolutely necessary; teamwork is also necessary; the lawyer should explain to the accountant in advance the high points in the case before him; the accountant should prepare his transcripts and analyses with proper headings thereon to indicate what they really are; and the accountant should listen carefully to the questions put to him on the witness stand, and if under cross-examination, be careful not to answer "Yes" or "No" without some qualification unless the question justifies such answer. Wise lawyers and accountants are those who can keep in mind the high points and build the case up around the high spots. They should avoid immaterial and unimportant things.

As to the question of stating accounts, a peculiar practice has grown up in receivership matters. I think it is justified. The statement of a receivership account in the federal court is quite different from the statement of a fiduciary's account in the Orphans' Court, at least in so far as Pennsylvania is concerned. The accountant (fiduciary) in an Orphans' Court case must charge himself with the amount of the inventory and appraisement which has already been filed. The accountant, having charged himself with that amount, then proceeds to charge himself with any additional assets which come into his hands, of course keeping principal and income in separate accounts, and the accountant credits himself with any payments made, and strikes a balance. He then makes a recapitulation of the debits and credits in the principal account, and the debits and credits in the income account. In receivership matters we seldom if ever state an account that way.

The inventory and appraisement in the federal court is made by three disinterested appraisers, and in the Pennsylvania state courts by two such appraisers. The assets are usually itemized and two values given, one a going-concern value, the other a liquidating value. When stating an account in receivership, the receiver seldom charges himself with the total amount of the inventory and appraisement, although, of course, he is chargeable in law with what he actually receives, and with the proceeds of the sale of any real or personal property which has been sold under order of the court. Generally speaking, the account is carried as a cash receipt and cash disbursement proposition. From a practical standpoint, it has been found advisable to do it this way.

In the federal court, generally speaking, a receiver in equity will file a partial account, secure allowances for administration expenses, etc., and pay a dividend thereon. No final account is filed until all assets are collected. The equity rules are now being revised and limitations will doubtless be imposed upon the filing of such partial account except by special leave of court upon application of some party of interest. Personally, I think it is a good thing to file a partial account because it hastens the payment of dividends to creditors. Receiverships frequently continue for several years while creditors wait for their money.

In a recent case involving a motor truck company which we handled, we found a most peculiar situation. This company got into financial difficulties in 1923 and made an assignment for the benefit of creditors to a large trust company. The court found that this trust company had handled the case in a grossly negligent manner. It had an itemized inventory of thousands of parts used in the manufacture of motor trucks, but there were absolutely no prices on them. The assignee set up no trust account on its ledger. It delegated practically all its powers to the former treasurer of the company and permitted him to make a profit for himself out of some of the trust assets. It handled the assets as if they were a cash receipt and disbursement proposition entirely, without keeping a proper record of either the receipts or disbursements. Certain creditors and stockholders became dissatisfied and filed a bill in equity in the federal court and secured the appointment of receivers. The receivers put accountants on the books and for the first time ascertained the manner in which the assignee had handled these trust assets. The receivers filed a bill for accounting against the former assignee, insisting that although the books of the insolvent corporation were wrong in some respects in the subsidiary accounts, they were correct in the control accounts, which governed. The matter was referred to a master who heard a mass of testimony over a period of two years. He wrote a lengthy report in which he found the assignee guilty of gross negligence and surcharged it with commissions of several thousand dollars and awarded a judgment for $26,000 on the merchandise account and $5,000 on the note account. The district court reversed this so far as the merchandise account was concerned; both sides appealed and the court of appeals affirmed the district court.

The legal problem involved was this: Where one fiduciary is guilty of gross negligence in failing to take a priced inventory at the outset and keeping proper records thereafter, and is succeeded by another fiduciary representing creditors, *on whom* is the burden of proof to show both quantities and values? Our contention was that both common sense and justice tell us that the burden is on the fiduciary who was guilty of gross negligence and not upon the creditors who were beneficiaries of the trust.

After the foregoing address, questions were put to Mr. Granger and he answered as follows:

Q—Is there anything compulsory in the law about having receivership property appraised, or is it optional?

A—It is compulsory and the bankruptcy statute provides that three disinterested appraisers must be appointed to inventory and appraise the assets.

The same rule applies in federal equity practice. In equity practice in Pennsylvania only two appraisers are appointed, but the same duties are imposed upon them as in the federal courts.

Q—Under what conditions can a receiver in equity be dismissed and a receiver in bankruptcy be appointed?

A—Prior to the 1926 amendment of the bankruptcy act, a receiver appointed by a court of equity could not be dismissed or supplanted by the filing of a bankruptcy petition unless such receiver was originally appointed *because of insolvency* of the defendant. Since the amendment of 1926, such receiver can be dismissed or supplanted if it is shown that he was appointed at a time *when the defendant was insolvent.*

Q—Does the same thing apply to partnerships?

A—In bankruptcy the same principle would undoubtedly apply to partnerships. There was, however, for some time a question whether a receiver could be appointed for a partnership in the federal courts of Pennsylvania upon a bill filed by a simple contract creditor and a constant answer. This doubt has since been resolved in favor of making such appointment. In the Pennsylvania state courts, there are many cases of disputes between partners, which culminate in the appointment of receivers for the partnership.

Q—What is the status of a claim where a mill sold goods on consignment, same having been sold and not remitted for prior to receivership?

A—We should remember the distinction existing between a receiver in equity and a receiver in bankruptcy. The receiver in equity is bound to segregate any property or the proceeds thereof upon which a trust is imposed. The consignment agreement drawn in proper form does impose a trust. The receiver should keep this property or its proceeds separate and if the claimant can trace the property or its proceeds into the receiver's hands, he would have a right to follow and recover them.

In bankruptcy a somewhat different situation exists. The receiver has nothing to do with the property sold on consignment except to hold it or its proceeds until the trustee in bankruptcy is elected. Of course, after the election of the trustee, the same duties are imposed upon the trustee to keep the property or its proceeds separate as are imposed upon a receiver in equity and the claimant may recover if able to trace the property or its proceeds.

Q—In bankruptcy is it not true that the Government, whether state or federal, is in no better position with respect to claims for taxes, but must file a proof of claim?

A—This is true so far as the necessity for filing a proof of claim in bankruptcy is concerned, but, of course, under the bankruptcy act such taxes have priority in distribution.

In answer to a question as to the status of a conservator of a bank, Mr. Granger referred to an insurance company case which he handled some years ago where a court at Harrisburg had, through a petition filed by the insurance commissioner, issued an order to show cause why the insurance commissioner should not take possession of the company and its assets. While this order was pending a simple contract creditor filed a bill in equity in the federal court with a consent answer and obtained the appointment of a receiver. The federal court was informed of the

existence of the state court proceedings, but apparently believed that no further action would be taken therein. The United States District Court held that in spite of the statutes of Pennsylvania giving jurisdiction over insurance companies to the state court, the federal court also had a concurrent jurisdiction, and that the court which first appointed the receiver and actually took possession of the defendant's assets would have the right to hold the same. The Circuit Court of Appeals, however, reversed this decision, and I think properly so, holding that the state insurance statutes provided exclusive methods of supervising and liquidating insurance companies; that the mere issuance of an order to show cause, when the ultimate purpose was to acquire possession of the property, was equivalent to the actual seizure of the property. Therefore, the federal receiver must surrender possession to the insurance commissioner.

Q—Where do referees in bankruptcy come in?

A—Their duties are fixed by the bankruptcy act. They are judicial in their nature. They pass on disputed questions of fact and make rulings thereon. They receive proofs of debt. They report their proceedings to the court. Their powers are somewhat similar to those of a master in equity. Their findings on disputed questions of fact carry great weight with the court.

Incidentally, I am reminded of a bankruptcy case which is extremely interesting and extremely fraudulent. An individual engaged in a food brokerage business was put into bankruptcy. It was then ascertained that he had less than $30,000 worth of assets left. He carried three bank accounts in one bank, one in his name of Smith, another Smith & Company, and a third Smith & Company, Inc. He also had another account in the name of Smith & Company at another bank, and an inactive account in his individual name at a third bank. He conceived the scheme of incorporating his business some years ago and began kiting and cashing checks. He would go to the bank where he kept his inactive account with a check for, say, $7,000 containing a fictitious payee's name. He endorsed this check, getting the cash and depositing it at the other bank where he had been kiting checks. Of course, he could do this only through the dishonesty of the cashier and the teller of the bank which cashed the checks. When discovered a year later they were discharged. His operations were enormous. He cashed 1,200 checks, aggregating over $4,500,000. As a result of our examination in the bankruptcy case, we started two proceedings, one against this individual to recover thousands of dollars in the turnover proceeding, and another against one of the banks to recover thousands of dollars as preferential payments. The case is still pending and involves complicated questions of bankruptcy law. We find in bankruptcy practice that two of the most familiar proceedings from an accounting and legal standpoint are those relating to turnovers and those to recover preferential payments. A heavy burden is imposed upon a trustee in bankruptcy to prove the facts in both cases.

Q—Under what conditions is it necessary for a receiver or trustee to obtain permission from the court before employing accountants to make an examination in an insolvent estate?

A—No receiver or trustee is safe in employing accountants unless he first

files a petition in court and gets a court order; otherwise, the receiver may have trouble later when a substantial bill is submitted by the accountants.

Q—To what extent has a receiver authority to instruct a bank to honor checks?

A—I don't think he would have any authority. The theory is that when bankruptcy proceedings are filed or a receiver in equity for an insolvent is appointed, the rights of the creditors are fixed.

Q—What is the effect of failure to keep accounting records in a bankruptcy case?

A—The failure of any individual or corporation in business to keep accounting records is evidence of fraud. The reason is obvious—no business can be properly carried on without proper accounting records.

Q—What is the liability of appraisers for appraising assets of wholly owned foreign subsidiaries?

A—The court always appoints the appraisers. Of course, any order made by the court would protect individuals who were ordered to do certain things. If the order directed the appraisers to appraise assets of wholly owned foreign subsidiaries, they would be fully protected in doing so by the order itself. This whole question of the extension of a receivership over a wholly owned subsidiary is unusual, and, in our judgment, should not be followed except in clear-cut cases of absolute necessity to conserve and protect assets. Generally speaking, it is improper to permit either the main receiver or a creditor on an ex-parte petition without hearing the facts to extend a receivership over a foreign subsidiary upon the mere allegation that it is wholly owned by the insolvent corporation.

Q—In this connection, how do you differentiate between the securities and the subsidiaries owning or holding the securities?

A—A corporation in the eyes of the law is a separate entity. A subsidiary corporation, of course, may be created by the parent company as the means of perpetrating a fraud or as a mere instrumentality or adjunct of the parent's business. When these facts are *legally proven*, there seems to be no reason why a receivership should not be extended over a wholly owned subsidiary. Until the facts are legally proven, I think in all justice to the creditors of the respective corporations and all parties in interest no such extension of receivership should be made, except possibly in the most extreme cases where there is danger of dissipation or loss of assets and quick action is required.

Let me interpose at this point in relation to ancillary receiverships:

In some recent cases, the court has made orders appointing ancillary receivers on the application not of the main receiver, but of outside creditors. We think this is improper because it is an elementary rule both in bankruptcy and in equity that ancillary receivers must be appointed *in aid* of the main receiver. If the court of primary jurisdiction and the main receiver, who is an officer of that court, do not see the necessity of ancillary appointments in other jurisdictions, generally speaking, no such ancillary receiver should be appointed. An exception might arise where the main receiver *improperly* failed or refused to apply for an ancillary receiver who should be ap-

pointed in another jurisdiction to protect and conserve assets there located. Another exception *might* exist if there is danger of a *speedy dissipation* or conversion of assets in the ancillary jurisdiction.

Q—A bankrupt corporation operated and conducted a theatre. The property was offered at public sale and lump sum bids were requested. Counsel for a large corporation, operating a chain, bid a lump sum for the property. Separate bids were then requested. The referee decided that the interests of the creditors would be better served by accepting separate bids. In reality, the interests of the creditors would have been better served if the whole property had been sold to the chain.

First: Would a creditor have the right to procure a review of the referee's decision?

Second: Would any bidder have the right as a bidder to procure such a review?

A—The trustee or any creditor who was injured by the referee's decision has the right to file a petition for review within ten days, and a bidder whose bid had been accepted and later rejected has the same right.

Causes of Bankruptcy

By R. F. Grover
(New York Office)

The United States Department of Commerce has issued two reports dealing with the causes of bankruptcies, which should be of particular interest to accountants. One of the reports (D. C. S. No. 54 November, 1931) is based upon studies of 612 cases of bankruptcy and other failures of *individuals* in New Jersey in 1929 and 1930. Mr. Frederick M. Feiker, Director of the Bureau of Foreign and Domestic Commerce, states in his foreword:

> This report . . . shows that more failures resulted from inefficient business methods and practices than from any other cause. *More than half of the concerns studied either kept no books at all or kept inadequate records, and 39 per cent of them never took an inventory.* Poor credit methods were evidenced by excessive losses from bad debts. The average open-credit losses of retailers were eight times as great and the average installment credit losses five times as great proportionately as those of going concerns. Some of those who failed engaged in speculation outside of business, and others speculated unwisely in carrying on their regular business. (Italics supplied)

The report further states:

> Of this number (612 cases studied), 487 were business establishments and 125 were wage earners and professional persons. Included in the business group were 102 contractors, 8 farmers, 28 manufacturers, 33 real-estate dealers, 301 retailers, and 15 wholesalers.
>
> An analysis of the data seems to indicate that business depression was the occasion rather than the cause in many, if not most, of these cases. The real cause was the inefficient business practices of the one who failed. Having kept no books, never taken an inventory, extended credit unwisely, and engaged in other practices not consistent with the commonly accepted principles of

sound business, when adverse conditions came he failed, while his more efficient competitor was able to weather the storm.

The liabilities exceeded the scheduled assets by more than $14,000,000 for the 602 cases concerned. This figure represents the minimum loss to creditors. In addition to the loss of creditors, the owners themselves presumably lost everything they had ever put into the business.

The lack of records is frequently accounted for by owners on the ground that the businesses are small, that the owners are too busy, or that they can not afford to hire qualified bookkeepers or accountants. However, if one may judge the size of these concerns by their liabilities, which indicate the amounts of money that went into them, some of the largest kept either inadequate records or none at all.

Of the 295 concerns reporting on the subject of inventory, 115, or 39 per cent, never took an inventory. Inventory taking was probably not so important for some of these types of business as for others, but it will be noticed . . . that 31 per cent of the retailers and 40 per cent of the wholesalers, among whom regular inventory taking is considered good business practice, never took an inventory.

The report does not so state, but it is a fair assumption that public accountants were not employed by any of the debtors who kept no books or inventories, nor by many (if any) of those who kept records.

A later report, dated September, 1932 (D. C. S. No. 69), deals with a similar analysis and study of 570 *commercial* bankruptcies occurring in Boston, Mass., during the period from November, 1930 to June, 1931.

In his foreword Mr. Feiker states:

Individual and commercial failures are, in general, preventable. . . . Few attempts have been made to secure the experience of unsuccessful business ventures for the consideration and benefit of others faced with similar difficulties of conducting a business profitably.

While views may differ as to the extent to which business failures are preventable, every one will concede that they should be minimized in number and in amount of loss. It is believed that the wider use by both grantors and users of credit of the services of public accountants, with their intimate contacts and experience with the histories of both unsuccessful and successful businesses, will aid in securing this result.

In the 1925 edition of the *Financial Handbook*, edited by Colonel Montgomery, it is stated that:

Before a new account is opened or a new credit extended the credit manager should be able to foresee *a probability of payment*, together with the possibility of enforcing payment if later it should be found necessary. (page 898)

In instances such as the 564 cases reported upon by the Department in which 51.5 per cent. of the bankrupts had no books at all and another 27.9 per cent. had inadequate books, how could creditors, relatives, proprietors or any one else have foreseen "a probability of payment" or "a possibility of enforcing payments"?

In the following summary of the Department findings, the emphasis placed upon the judicious granting of credit and the need for proper accounts and reports is noticeable. The italics are supplied.

1. The major causes of bankruptcy disclosed by the data analyzed in this study are inefficient management, *unwise use and extension of credit*, adverse domestic and personal factors, and dishonesty and fraud.

2. The lack of economic opportunity, ability, and other requisites for successful business operation prevented the majority of the bankrupts from succeeding. Their failure was, therefore, a consequence of an unjustifiable entrance into business.

3. *Indiscriminate and careless granting of credit to the bankrupts by incurious creditors* enabled many to start and to continue a business in which failure was inevitable.

Three hundred and fifty principal creditors admitted that they did not know the causes of failure in 249 of their debtor concerns.

4. Over 68 per cent of the owners or managers had not completed a high-school education.

5. *Over 51 per cent of the bankrupt businesses had no accounting records.* A consideration of all direct and related evidence revealed that the accounting records of an additional 28 per cent of the bankrupt concerns were inadequate for the needs of the business.

6. The open-credit losses of the bankrupt establishments for the year prior to failure amounted to 5.6 per cent of open-credit sales, which is approximately nine times greater than the bad-debt losses of active concerns.

7. Prior to ownership of their concerns, nearly half of the bankrupts were engaged in occupations which did not provide any experience in the business they entered.

8. Only five per cent of the 564 bankrupts reporting on the subject used credit bureaus.

9. Approximately 53 per cent of the owners had difficulty in paying creditors from seven months to two years prior to their bankruptcy.

10. In 72 per cent of the cases the amount of capital invested by the owners and creditors in the bankrupt enterprises at the date of their organization amounted to only $5,000 or less. Included in this group are 124 concerns in which $500 or less was invested by the owner and his creditors at the date of organization.

* * *

13. *A large proportion of commercial failures can be prevented by (1) maintenance of proper accounting records* and efficient operation of a business by its owner, (2) *selective and wise credit extension by creditors, and* (3) enforcement of penalties for dishonest and fraudulent acts.

Elsewhere in the report it is stated that:

. . . inefficient management is the cause of more commercial failures than any other single cause.

The part which management plays in the success or failure of an enterprise is obviously a leading one. The efficiency of management should be the foremost criterion of credit worthiness. Its technique lies partly in the science of accountancy. *Accounting records* reveal the inefficient parts of a business and are a necessary guide in formulating policies for reducing the costs of doing business.

One evidence of efficient management is *adequate accounting records. . . .*

Unless rent and salaries, usually the two largest overhead expenses in the majority of businesses, are in proportion to the volume of sales, failure is imminent. *The profit and loss statement* reflects the efficiency of management, and the appearance of excessive overhead costs is an indication of inefficient management.

In a recent address before the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants, which appears elsewhere in this issue, Percival H. Granger, Esq., of the Philadelphia Bar, replied to a question from the floor as follows:

Q. What is the effect of a failure to keep accounting records in a bankruptcy case?

A. The failure of any individual or corporation in business to keep accounting records is evidence of fraud. The reason is obvious—no business can be properly carried on without proper accounting records.

The L. R. B. & M. Journal

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The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest and to help in the solution of common problems.

Co-operation Between Bankers and Accountants

A meeting of the Society of Certified Public Accountants of the State of New Jersey on April 25, 1933 was devoted to the above subject. A number of New Jersey bankers were present as guests of the Society, and Colonel Montgomery was present as one of the speakers of the evening. The meeting was in a way the culmination of several years of contact and study of mutual problems by cooperating committees named by the Society and by The New Jersey Bankers Association.

Following the meeting a Tentative Report for Consideration of Bankers and Certified Public Accountants, which had been prepared and submitted by the cooperating committees above referred to, was published.

The following foreword by Colonel Montgomery is contained in the report:

More than at any other time in our history business men need credit facilities; more than at any other time banks need and desire to make safe loans; more than at any other time the certified public accountant is in a position to render constructive service to the borrower and to the lender.

The service to be really effective must extend over the entire year. Such service during the latter nine months of the year would probably be still more helpful and constructive than that during the three congested months of January, February and March.

What we need is action. The progress made by the bankers of New Jersey and the certified public accountants of that state in working together and developing a plan for further cooperation is surely the fore-runner of more intimate relations that will play an important part in the rehabilitation and encouragement of business.

In times past the bankers and the accountants have cooperated to their mutual

advantage. In each successive year we have become wiser because we have profited by experience. Let us accelerate the cooperation. If a little was helpful why not try out active, continuous cooperation every month in the year!

I suggest that this question be discussed. Should every borrower and prospective borrower have for the successful administration of his business a budget broken down into monthly periods? If the answer is "yes," should the banker have a copy? If the answer is "yes," should not the banker say to his customer that he wants the working out of the budget frequently checked by a certified public accountant?

The New Jersey Bankers Association and the Society of Certified Public Accountants of the State of New Jersey have made considerable progress in getting together to help themselves and to help their mutual clients. The reports herewith prove the worth of the efforts to this date. I again strongly urge that the work be accelerated.

The foreword quoted above sums up briefly the thought expressed by Colonel Montgomery in his talk at the Society's meeting.

Receiverships and Bankruptcies

We are indebted to Percival H. Granger, Esq., of the Philadelphia law firm of Messrs. Reber, Granger & Montgomery, for the article bearing the above title which appears in this issue of the L. R. B. & M. JOURNAL. It represents an address by Mr. Granger, and the discussion which followed, at a recent meeting of the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants which had been arranged by the Committee on Cooperation with Bar Associations and to which each accountant was requested to invite a lawyer as a guest. Approximately two hundred members and guests attended.

Mr. Granger's address is of especial interest to us because of the special attention it gave to the accountant's work in receiverships and bankruptcies. The discussion is of value because it dealt with questions raised by both lawyers and accountants who attended the meeting.

Notes

Colonel Montgomery is one of three American accountants who have been requested to read papers at the International Congress on Accounting to be held in London during July, 1933. Colonel Montgomery's paper will deal with "The Auditor's Responsibility in Relation to Balance Sheets and Profit and Loss Accounts from the American Point of View."

Mr. Staub was elected President of the New York State Society of Certified Public Accountants at the annual meeting of the Society on May 8, 1933. Mr. Staub had served as First Vice-President of the Society for the past three years. He expects to represent the Society at the International Congress on Accounting in London.

The May, 1933 issue of *The Tax Magazine* contained an article on "Proposed Surrender of State Taxing Power," by Mr. George W. Elwell of our Boston office.

A Regional Conference on Accounting sponsored by the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants was held in Philadelphia on May 16th and

17th. At the evening meeting of the first day Mr. Staub addressed the meeting on "Accounting Requirements of the New York Stock Exchange."

Mr. Fischer has been elected Vice-Chairman of the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants, and Mr. Russel has been elected Treasurer of the Pennsylvania Institute of Certified Public Accountants. Mr. Russell has also been elected Executive Vice-President of the Philadelphia Chapter of the National Association of Cost Accountants.

The Cotton Digest of May 20, 1933 contained an article on "The Merchant and Accounting," by Mr. Mohle, Manager of our Houston office.

Mr. Ives, Manager of our Atlanta office, spoke on "Branch Office Accounting" at the joint May meeting held by the Atlanta Chapter of the National Association of Cost Accountants and the Georgia Society of Certified Public Accountants.

The following note is taken from the May 15, 1933 *N. A. C. A. Bulletin:*

> Congratulations to Donald P. Perry, President of the Massachusetts Society of C. P. A.'s and a partner of Lybrand, Ross Bros. & Montgomery, for his recent article in the New England News Letter on "The Question of Writing Down Plant Assets." In our opinion the article represents the most complete, yet concise, exposition of the subject which we have seen.

The American Accountant of June, 1933, contains an article on the "Statement Presentation of Noncurrent Gains and Losses," by Herbert G. Bowles of our Los Angeles office.

An article on "Accounting for Bottling Departments of Breweries," by W. D. Buge and Henry Hufnagel, recently appeared in the *Western Brewer.*

Bunkers Club Tournament

After all the wet weather we have had recently, the weather man was kind enough to provide a good, hot day for our Bunkers Club Tournament on June 7th, in which thirty-one players participated at Valley Forge Golf Club. The prize for low net score, the Hood Cup, was won by George Compton, one of our office boys, who was in exceptionally good form. Needless to say, his handicap will undergo a major operation prior to our next tournament.

Interest was particularly keen in the tournament this year, due to the fact that Messrs. Ross, J. M. Pugh and Sohner have each won the cup twice, which becomes the permanent property of a three-time winner. Several other members of the staff have one leg of the cup to their credit.

Probably the most interesting round of the day was that played by T. E. Ross, J. M. and J. J. Pugh. Mr. Pugh is under doctor's orders to play only nine holes at a time, so dropped out of the half-way mark. Mr. Ross and Joseph J. Pugh continued on, Mr. Ross finishing with a 90, the low gross score. He needed only an 89 to have taken permanent possession of the cup, but visited too many of the concave beaches which, unfortunately, happen to be near the greens at Valley Forge. Joseph Pugh required 91 strokes; his motor boat imitation was perfect—43 putts for the 18 holes.

Two members of the staff happened to strike the kickers' handicap score, so that prize was divided between C. Herbert Libby and Walter R. Seibert.

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